1 Concept

Price stability as goal of monetary policy

The monetary policy of the Swiss National Bank aims at keeping the price level stable in the medium term and allowing the economy to make full use of its production potential. Stable prices are an important prerequisite for the smooth functioning of the economy. By increasing the money stock no further than to enable the economy to grow in keeping with its production potential, the National Bank contributes to a balanced development of domestic demand for goods and services. Under such conditions the price level also remains stable. An excessive expansion of the supply of money would trigger excessive demand. Overall economic capacity would be stretched, causing prices to rise. An inadequate supply of money, by contrast, would hamper production; the economy would suffer losses of growth and possibly a decline in the price level.

Smoothing cyclical fluctuations

Price stability as a goal does not imply that monetary policy takes no account of the state of economic activity. Our policy helps to smooth cyclical fluctuations. If economic capacity is not fully utilised, an expansion of the supply of money in step with the production potential will lead to interest rate reductions. Monetary policy thus serves to support demand and helps to remedy underutilisation. If, however, economic capacity is overstretched, a potential-oriented monetary policy triggers interest rate rises. This curbs demand and acts against cyclical overheating. Moreover, we retain the option of reacting to unexpected developments – such as strong shifts in exchange rates or in the demand for money – in order to keep the damage to the real economy as small as possible.

Orienting monetary policy to the monetary base

We orient our monetary policy primarily to the monetary base. The latter serves as an indicator whether the supply of money conforms to the economic production potential. The monetary base is a narrowly defined aggregate. It is made up of bank note circulation and the balances held by the commercial banks at the National Bank. In principle, it would be possible to orient monetary policy to a more broadly defined monetary aggregate such as the money stock M_1 (currency in circulation outside banks plus sight and other transaction deposits of the nonbank public), M_2 (money stock M_1 plus savings deposits) or M_3 (money stock M_2 plus time deposits). A change is not indicated, however, as the monetary base can still be forecast quickly and fairly accurately. Moreover, the broad aggregates react more strongly to interest rate changes than the monetary base. In the short term, this impairs their relevance as monetary policy indicators. Nevertheless, we closely observe their development in order to review the indicator role of the monetary base.

Medium-term target path for the development of the monetary base

A medium-term target path serves as a guideline for the development of the monetary base. It shows the direction in which the supply of base money should be adjusted. Given regular economic growth – accompanied by price stability and normal utilisation of potential output – demand for money would follow this line. Fixing a medium-term target path permits us to react appropriately to unexpected exchange rate fluctuations and other disruptions in the economic equilibrium. The course of monetary policy can therefore temporarily deviate from the target path. Nevertheless, in order to render our policy transparent at all times, we inform the public regularly of our intentions in the field of monetary policy and forecast the development of the monetary base.

Target path end-1994 to end-1999

At the end of 1994, we fixed a target path for the seasonally-adjusted monetary base for a period of five years to the end of 1999. The target path corresponds to an average growth rate of the monetary base of approximately 1% p.a. This is in keeping with an estimated increase of 2% in potential output and an annual inflation rate of 1%, which is treated as price stability. The envisaged expansion of the monetary base by 1% is below the nominal economic growth rate of 3% on which the target path is based. The shortfall reflects the rising trend towards cashless payments. As a result, banknote circulation tends to increase more slowly than national product.

Fundamentals of monetary operations

We influence the supply of money by adjusting the amount of liquidity provided to the banking system, with a corresponding impact on money market rates. In this way, we regulate the level of sight deposits which the banks hold with the National Bank and enable market participants to trigger interest rate movements in keeping with our monetary policy course. Interest rate fluctuations that run counter to our monetary policy are, however, not excluded. In such cases, we are prepared to exert an influence on the development of interest rates by adjusting the supply of liquidity or by temporary direct steering of the call money rate. We thus ensure an orderly development of money market rates.

Central role of banks' sight deposits and of call money market

Supply and demand for bank liquidity are balanced in the call money market. We employ our monetary instruments for regulating the supply of sight deposits held at the National Bank. The banks' demand for such deposits is due mainly to statutory liquidity requirements, but also to the need for operating funds for cashless payment transactions. Compared to daily liquidity movements within the banking system and between banks and nonbanks (including the Confederation and the postal service), the volume of sight deposit balances is small. We therefore operate regularly in the call money market in order to guarantee an adequate supply of liquidity.

Precedence of open market operations

We control the banks' sight deposit holdings with the National Bank by concluding transactions with the banks at market conditions. In order to maintain our freedom of action, we generally supply the banking system with liquidity for only a limited period through open market operations with swaps (by buying assets and at the same time selling them forward). We meet basic requirements for liquidity by means of foreign currency swaps – Swiss francs against dollars with maturities ranging from 1-12 months – which, as a rule, are renewed after repayment. For providing the market with liquidity in the short term, we usually transact swaps with debt register claims. We also make use of the opportunity to place short-term time deposits of the Confederation at banks. This enables us to adjust differences in liquidity between the banking system and the Confederation.

Instruments for money market operations in Sfr billions

	1995 Holding (annual average)	1995 Turnover	1996 Holding (annual average)	1996 Turnover
Foreign exchange swaps with maturities				
up to 1 month	0.5	2.9	0.1	0.5
over 1 month to 3 months	7.4	10.5	5.0	10.2
over 3 months to 12 months	2.4	25.0	3.7	25.9
Total	10.3	38.4	8.8	36.6
Money market debt register claims				
Swaps	1.0	79.9	0.9	78.9
Purchases and sales	0.7	4.3	0.8	4.0
Total	1.7	84.2	1.7	82.9
Federal Government funds				
New investments	5.4	58.2	3.9	74.7
Onward placements	3.0	34.1	2.2	62.2

Advances against securities in an emergency

If a bank has urgent liquidity needs which it cannot meet in the money market, it may obtain an advance against securities (Lombard loan) from the National Bank. A Lombard loan, however, is limited to the amount of the collateral provided in the form of securities and granted only at the official Lombard rate. This rate is constantly kept at two percentage points above the call money rate to discourage banks from using the Lombard loan as a permanent source of refinancing.

2 Implementation

A more expansionary monetary policy than announced ...

The unexpected economic downturn induced the National Bank to pursue a more expansionary monetary policy in 1996 than announced at the end of 1995. We endeavoured to provide the economy with sufficient monetary leeway for a rapid cyclical recovery and to counteract deflationary pressures emanating from the strength of the Swiss franc. At the end of 1995, we had expected the seasonally-adjusted monetary base to grow by more than 1% but considered it unlikely to reach the medium-term target path by the end of the year. In actual fact, between the fourth quarter of 1995 and the fourth quarter of 1996 the monetary base rose by 5%, thereby already exceeding the target path in summer.

... necessary due to the economic situation

Our initial assumption, at the end of 1995, had been that the Swiss economy would revive and real gross domestic product would grow by 1.8% until the fourth quarter of 1996. At the same time, we had anticipated an inflation rate of approximately 1.5% during this period. Towards mid-year, however, it became increasingly evident that there would be no economic recovery. Consequently the danger of a steady decline in prices grew. We were thus led to expand the monetary base more markedly than originally planned. This enabled us to keep money market rates more or less at the low level attained at the beginning of 1996. The low interest rates acted as a corrective to the excessive rise of the Swiss franc in the foreign exchange market.

Marked decline in savings deposit rates

The vigorous expansion of the monetary base does not simply reflect the monetary policy pursued in 1996. In the wake of a distinct relaxation of monetary policy in spring 1995, the savings deposit rates fell more steeply than expected at the end of 1995 and the beginning of 1996. Banknote circulation reacts to changes in monetary policy with a time lag of several months since it is influenced less markedly by money market than by savings deposit rates. The latter only adjust to changed money market rates after some delay.

Shift in demand for banks' sight deposits at the National Bank

Another reason for the strong expansion of the monetary base in 1996 is to be seen in the liquidity behaviour of various banks, which increased their sight deposit holdings at the National Bank and reduced their postal cheque account balances. Like cash and postal cheque account balances, these sight deposits help to meet statutory liquidity requirements. In contrast to sight deposits, however, postal cheque account balances do not form part of the monetary base. In order not to tighten our monetary policy course unintentionally, we adjusted the supply of base money by some Sfr 400 million on account of the higher demand for these sight deposits. Our stance was therefore not quite as expansionary as the growth of the monetary base seems to suggest.

Interest rate rise in mid-1996 not consistent with monetary policy

As a result of the expansionary monetary policy money market rates, which had already been declining steadily since spring 1995, fell to below 2% at the beginning of 1996. In the second quarter they moved up again. At first we took this as a sign of the anticipated economic recovery. Then, for the first time after a long period the Swiss franc started to weaken in the foreign exchange market, which normally leads to a certain amount of interest rate tension. In addition, distortions in the money market as a result of the already mentioned changes in the banks' liquidity behaviour made themselves felt. We counteracted interest rate tension by providing the money market with ample liquidity. At the end of September, we decreased the discount rate from 1.5% to 1%, thus underlining our willingness to keep money market rates at a low level.

Strong growth of the broadly defined monetary aggregates

The development of the broadly defined monetary aggregates, which react promptly and vigorously to interest rate changes, confirmed the picture presented by the monetary base. Already beginning in spring 1995, the decline in money market rates had led to a massive expansion of sight and savings deposit liabilities in the banking system to the detriment of time deposits. This development was interrupted by a temporary rise in interest rates in spring 1996. Nevertheless, all the broadly defined aggregates rose vigorously: in 1996 the money stock M_1 exceeded the previous year's level by 11.9% on average, the money stock M_2 expanded by approximately 12.2%, while the money stock M_3 increased by 7.2%.

Seasonally-adjusted monetary base

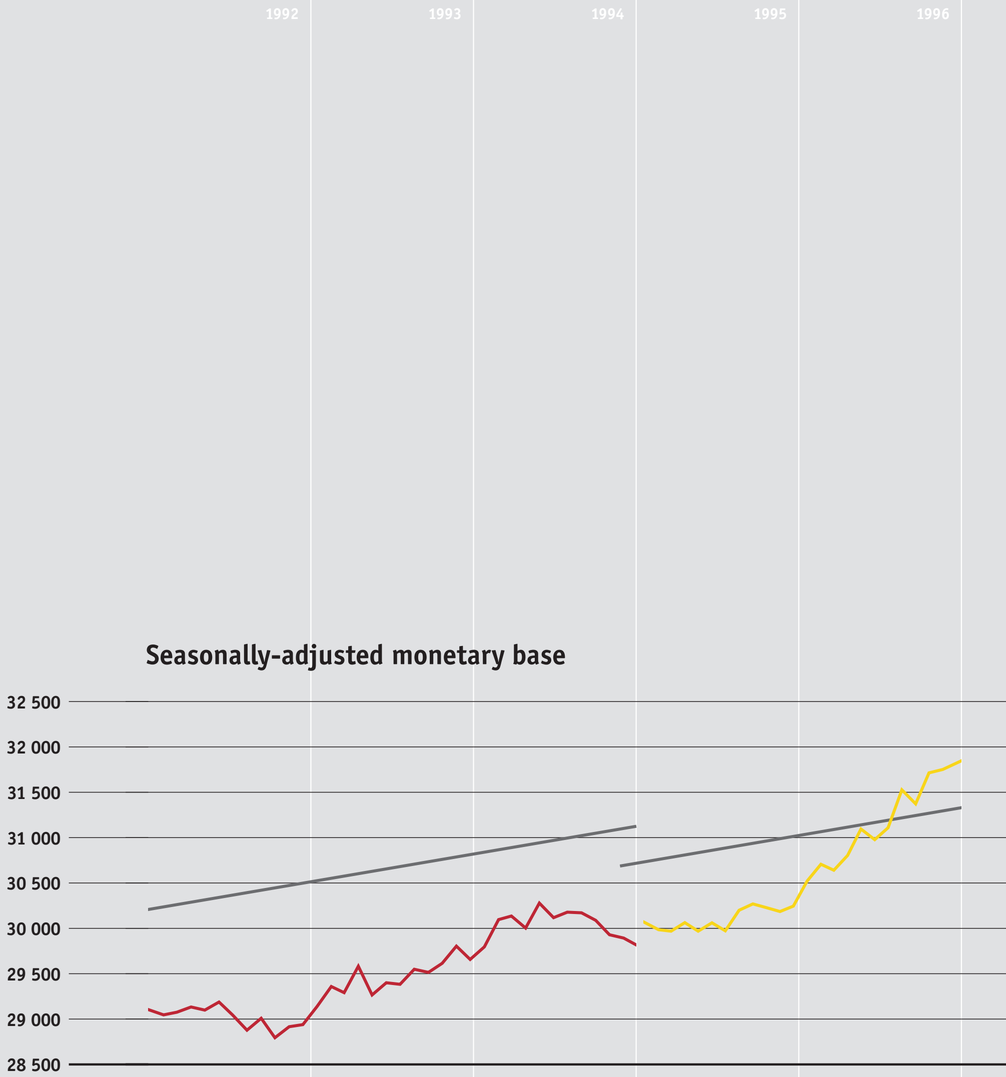
Monetary base until December 1994

Monetary base as from January 1995

Target path of 1%

In millions of Swiss francs

From January 1995 onward, sight deposits held at the National Bank solely comprise the balances of domestic banks. Until end-1994 they included deposits of a few institutions not subject to the Federal Law on Banks and Savings Banks.



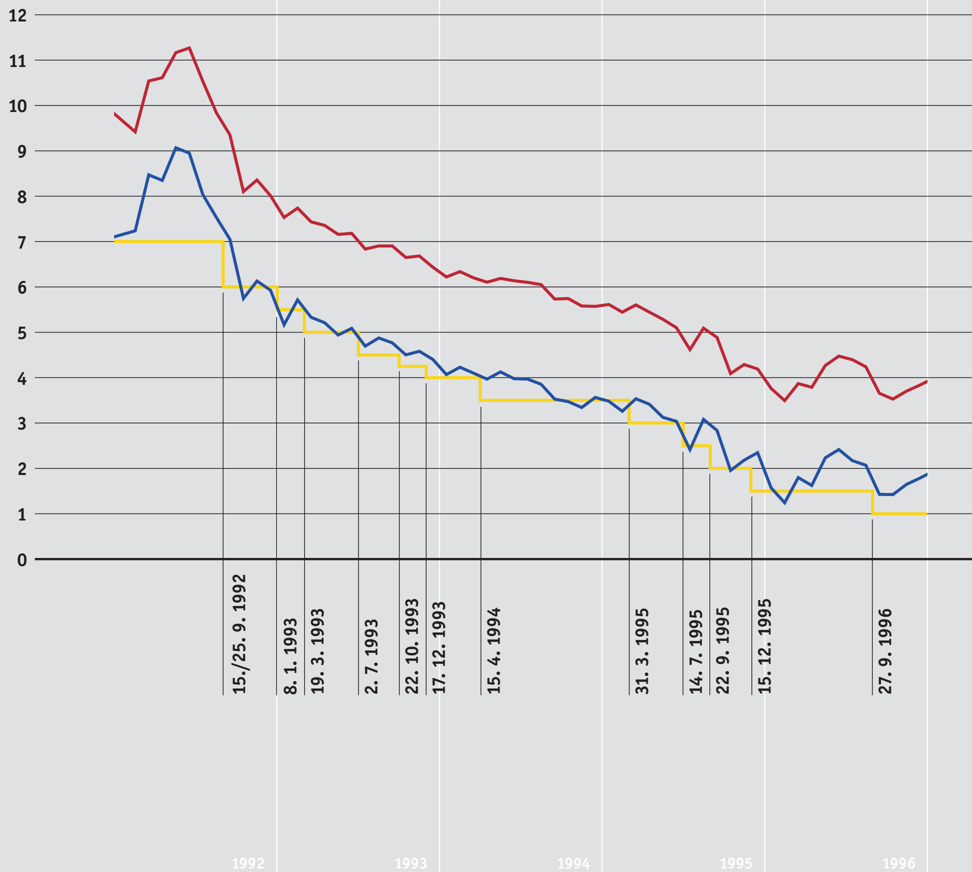
Discount and Lombard rates

Discount rate

Lombard rate

Call money rate

In percent



Monetary policy in 1997

The Swiss National Bank, in agreement with the Federal Government, will continue to pursue a relaxed monetary policy in 1997. We intend to keep the seasonally-adjusted monetary base above the medium-term target path. In so doing, we duly take account of the unfavourable economic situation and the uncertainties surrounding European monetary integration. The supply of base money will remain abundant, creating the monetary preconditions for economic recovery. We currently consider the inflation risks in Switzerland to be low. Yet we are aware that the time for a change of direction must be carefully chosen if price stability is to be maintained in the medium run. A change in monetary policy, however, will only enter into consideration once the Swiss economy is clearly on the path of recovery.

Hesitant economic recovery and low inflation in 1997

The monetary policy envisaged for 1997 is based on the expectation that real gross domestic product will increase by 0.5% and the average inflation rate will amount to 1%. Under these circumstances demand for base money is likely to show a moderate increase only. As usual, we retain the option of deviating from our monetary course in the event of serious disruptions in the financial markets.

Monetary base

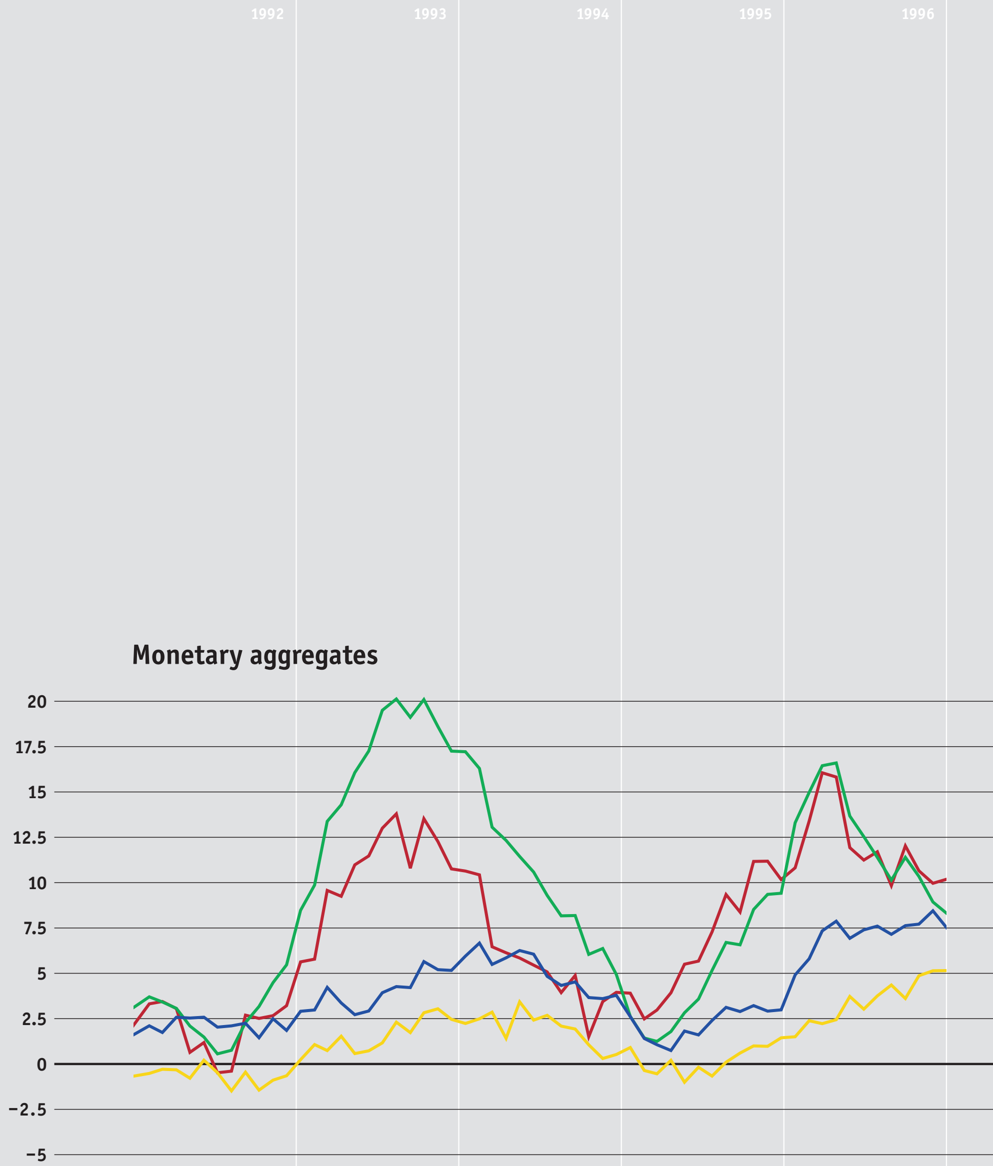
M_1

M_2

M_3

Percentage change from previous year's level

Monetary aggregates

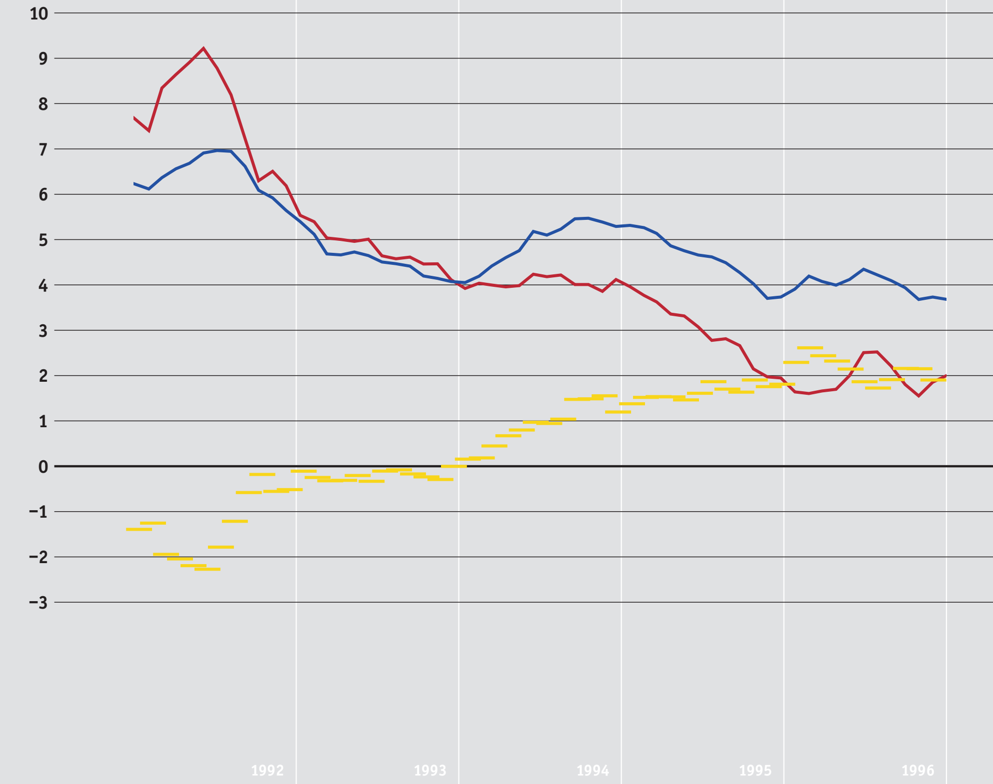


Euromarket rate on three-month Swiss franc deposits, in percent

Yield on federal bonds, in percent

Differential in percentage points

Money and capital market rates



3 Renewal of the note-issuing privilege

State-owned bank or joint-stock bank – an alternative under constitutional law

Under Article 39 of the Federal Constitution (FC), the Confederation has the sole right to issue banknotes. The Confederation may exercise this privilege through a separately organised state-owned bank or, subject to the right of repurchase, vest the note-issuing privilege in a central joint-stock bank administered with the co-operation and under the supervision of the Confederation. The National Bank Law (NBL) confers the note-issuing privilege on the National Bank by parliamentary decision for a period of twenty years. A resolution renewing the privilege was last passed by the federal parliament on 15 September 1976 for a period expiring on 20 June 1997.

Decree of the federal parliament on the renewal of the note-issuing privilege

With its message of 24 April 1996 the Federal Council submitted the draft of a federal decree to the Swiss parliament providing for the renewal of the National Bank's note-issuing privilege for a period of twenty years as from 21 June 1997. It argued on the grounds that the current regulation had proved satisfactory. By vesting the note-issuing privilege in a central bank organised in the form of a joint-stock company, the principle of independence would be realised to a high degree. A 'state-owned bank' would be subject to stronger political influence than a central bank constituted as a joint stock company; this alternative could therefore no longer be considered a viable solution. Both houses of parliament passed the motion unanimously, the Council of States in the autumn session and the National Council in the winter session of 1996.

4 Comments on the draft of the new Federal Constitution

An article on monetary policy was newly introduced in the draft on the reform of the Federal Constitution published in June 1995. This new article is designed to replace the former provisions in Art. 38 FC (coinage clause) and Art. 39 FC (central bank clause).

Comments of the National Bank

In its statement of 29 February 1996, the National Bank qualified the inclusion of an article on the monetary structure as an important element of the reform project. We were in favour of the subject being organised in a single constitutional norm concentrating on fundamental monetary principles. We also welcomed the proposal to sever the link between the Swiss currency and gold, the explicit constitutional competence of the Confederation in monetary matters and the embodiment of central bank independence in the Constitution. Furthermore, we pointed out that the central bank's commitment to the goal of monetary stability is today acknowledged worldwide as a basic principle of a monetary order. A clause in the Constitution orienting central bank policy to the goal of monetary stability, however, could have gone beyond the limits of a simple update. In order to maintain public confidence in the Swiss currency we suggested that the National Bank should be obliged by the Constitution to form adequate currency reserves from its earnings.

This suggestion was consequently taken up by the Federal Department of Justice and Police. On 20 November 1996, the Federal Council passed the revised draft of a new Federal Constitution and the message. In the updated Art. 89 of the draft Constitution, the Swiss National Bank is obliged to form adequate currency reserves. This rule is intended to replace, in function, the present constitutional obligation to provide cover for notes in circulation through gold and foreign exchange holdings.

Addition to the article on monetary policy